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IN THE MATTER OF THE
INVESTIGATION OF THE COST OF
TELECOMMUNICATIONS ACCESS

DOCKET NO. T-00000D-00-0672

STAFF MEMORANDUM OF LAW
ON PROCESS ISSUES

I. Introduction

On September 26, 2003, Staff of the Arizona Corporation Commission ("ACC" or "Commission") filed a motion for a procedural conference to discuss the Commission's directive at a recent Open Meeting to conduct an expedited review of Qwest Corporation's ("Qwest") access charges to determine whether they are cost based. At the Procedural Conference on October 14, 2003, Administrative Law Judge Nodes asked parties to file a legal memorandum on the issues of bifurcation and the Commission's ability to implement access charge reductions outside of a rate case given the holdings in Scates v. Arizona Corporation Commission, 578 P.2d 612 (Feb. 3, 1978) and US WEST Communications, Inc. v. Arizona Corporation Commission, 34 P.3d 351 (Nov. 15, 2001) ("US WEST II") Following is Staff's Memorandum of Law on the process issues raised.

II. Argument

A. The Commission Should Bifurcate Its Consideration of Qwest's Access Charges and the ILEC's Access Charges

1 In its Motion, Staff proposed that the Hearing Division bifurcate its consideration of
2 Qwest access charges and its consideration of ILEC access charges.

3 It was the Commission's desire, because of the concerns raised by AT&T
4 Communications of the Mountain States, Inc. ("AT&T") within the context of Qwest's 271
5 application regarding Qwest's access charges, that this issue with respect to Qwest be expedited.
6 Reviewing all of the ILEC access charges at the same time would result in delay in Staff's
7 opinion, and it would be difficult to resolve the issues as quickly than if Qwest's access charges
8 were subject to a separate review. If ILEC access charges are considered at the same time, new
9 issues and policy concerns will arise that are unique to ILECs. These issues and policies will
10 have to be examined for the 13 ILECs now operating in Arizona. Not only will this require
11 significant additional time for discovery but for review and analysis and presentation of the ILEC
12 related issues as well.

13 Another point of differentiation that supports separate consideration of ILEC charge
14 reductions, is the fact that access charges are a greater portion of the ILECs' revenues. The
15 ILECs' local service rates are also in some cases substantially higher to begin with than Qwest's,
16 thus from both a policy and rate design perspective they will be more difficult to address. Any
17 downward adjustments are likely to have a far greater potential impact on the local service rates
18 charged by the ILECs unless offset by Arizona Universal Service Funds ("AUSF").

19 Another important point of differentiation is that Qwest's switched access charges are
20 currently the subject of a stipulation. That stipulation includes the objective of ultimately
21 reducing Qwest's intrastate access to interstate levels. Decision No. 63487, Attachment A, page
22 3 of 6. The current price cap plan that is in effect for Qwest provides for annual switched access
23 charge reductions that are offset with a comparable increase in Basket 3 pricing flexibility. In
24 addition, Qwest has recently filed for review of its price cap plan. It is also likely that Qwest
25 will be filing for an intrastate rate increase when its Arizona financials become available.
26 Overall, however, the Qwest price cap plan and its related pricing flexibility provisions
27 constitutes a unique circumstance which supports different consideration.
28

1 WorldCom noted further that while ILEC charges are of concern to interexchange
2 carriers, the majority of the traffic that they deal with is Qwest traffic. Thus, it has the largest
3 economic consequence in terms of access reform. Tr. 13.

4 Finally, while Staff believes that the issue of ILEC access charges and the issues raised in
5 the current AUSF docket may have some cross-over, it would be better to address these issues in
6 two separate dockets. The issue of changes to the AUSF is likely to take the form of a
7 rulemaking. ILEC access charge reform is likely to be accomplished through an evidentiary
8 hearing process. In addition, many of the issues to be addressed in these two dockets will be
9 different.

10
11 **B. Any Rate Reductions Must Be Made Within the Context of a Rate Case or**
12 **Qwest's Current Price Cap Plan or in a Revenue Neutral Fashion Consistent**
13 **with Qwest's Current Price Cap Plan.**

14 Staff believes that the Commission has several options with respect to implementation
15 of any access charge reform that results from this docket.

16 First, with regard to Qwest, Staff believes that any access charge rate changes resulting
17 from this docket, must be done within the context of Qwest's current price plan, a rate case or
18 other proceeding in which the Commission determines Qwest's fair value, or in a revenue neutral
19 manner consistent with Qwest's current price cap plan.

20 In Arizona, the Corporation Commission is the body charged with the responsibility for
21 establishing utility rates which are "just and reasonable." Ariz. Const. art. 15, Section 3, A.R.S.
22 40-250. The general theory of utility regulation is that the total revenue, including income from
23 rates and charges, should be sufficient to meet a utility's operating costs and to give the utility
24 and its stockholders a reasonable rate of return on the utility's investment. See Simms v. Round
25 Valley Light & Power Co., 194 P.2d 378, 383 (1956). To determine this the Commission must
26 first determine the "fair value" of a utility's property and use this value as the utility's rate base.
27 The Commission then must determine what the rate of return should be, and then apply that
28 figure to the rate base in order to establish just and reasonable rates. Arizona Corporation

1 Commission v. Arizona Public Service Corporation, 555 P.2d 326, 328 (1976). The Court in
2 Simms v. Round Valley Light & Power Co., 294 P.2d 378, 382 (1956) further stated:

3 "It is clear...that under our constitution as interpreted by this court, the
4 commission is required to find the fair value of (the utility's) property and
5 use such finding as a rate base for the purpose of calculating what are just
6 and reasonable rates...While our constitution does not establish a formula
7 for arriving at fair value, it does require such value to be found and used as
8 the base in fixing rates. The reasonableness and justness of the rates must
9 be related to this finding of fair value."

10 In Scates v. Arizona Corporation Commission, the Court of Appeals held that the
11 Commission's action in approving an increase in certain telephone services was without
12 authority since there was no consideration of the overall impact of that rate increase upon the
13 return of the telephone utility and without the determination of the utility's rate base.
14 Consequently Scates stands for the general proposition that the Commission must consider the
15 impact of a rate change upon the utility's return after a determination of fair value rate base.

16 In US WEST v. Arizona Corporation Commission, 34 P.3d 351, the Court was presented
17 with the issue of the applicability of Scates in a competitive market. In that decision, the
18 Arizona Supreme Court stated:

19 "We still believe that when a monopoly exists, the rate-of-return method is
20 proper. Today, however, we must consider our case law interpreting the
21 constitution against a backdrop of competition. In such a climate, there is
22 no reason to rigidly link the fair value determination to the establishment
23 of rates. We agree that our previous cases establishing fair value as the
24 exclusive rate base are inappropriate for application in a competitive
25 environment.

26 It is important to note what we do not decide today. We do not hold that a
27 fair value determination should play no role in the establishment of rates,
28 or that it can simply be ignored. On the contrary, section 14 mandates that
the corporation commission determine fair value "to aid it in the proper
discharge of its duties. One of the commission's primary duties is to set
rates. See Ariz. Const. art. XV, Section 3."

Id. at p. 355.

Taken together, these cases suggest that even in a competitive environment, the
Commission must still consider fair value to aid it in the proper discharge of its duties. This also
suggests that the Commission must still consider the overall impact of any rate change on the

1 Company's overall authorized rate of return since fair value has little meaning outside of such a
2 rate of return determination. Simms at pps. 615-616.

3 Nonetheless, the cases, in particular Scates, appear to suggest that a revenue neutral rate
4 change would be consistent with the Commission's constitutional responsibilities. The Court of
5 Appeal's primary problem in Scates with what the Commission had done, was the fact that the
6 Commission had approved a rate increase without any consideration given to the costs of the
7 utility apart from the affected services, without any determination of the utility's investment, and
8 without any inquiry into the effect of a substantial increase upon a utility's rate of return.

9 Qwest's current price cap plan contains three service baskets: Basket 1 contains
10 noncompetitive services, including basic services and certain auxiliary services; Basket 2
11 contains wholesale services; and Basket 3 contains competitive services. Each basket is tied to
12 an overall revenue cap which was determined based upon the fair value rate base and rate of
13 return determined in the Company's last rate case. The plan further provides that switched
14 access charges, a wholesale service now contained in Basket 2, are subject to annual revenue
15 reductions which are offset by comparable increases in Basket 3. Thus, in Staff's opinion,
16 Qwest's current price cap plan provides for changes to particular rates which are accomplished
17 on a revenue neutral basis. Since the changes are revenue neutral, and set within the parameters
18 of the plan and the revenue levels of the various baskets which were set based upon a fair value
19 rate base determination and an analysis of the Company's overall rate of return, Staff believes
20 that they are consistent with Scates and US WEST II.

21 Staff believes that were the access charge reductions resulting from this case
22 accomplished on a similar revenue neutral basis, that such changes would be permissible under
23 Scates and the existing price cap plan and could be ordered by the Commission within the
24 context of the current proceeding.

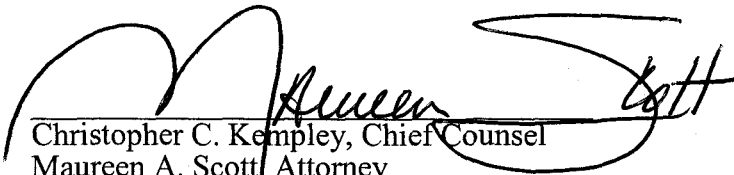
25 Staff also believes, however, that after the consideration of the magnitude of any access
26 charge changes is determined, any proposal to increase Basket 1 services through imposition of a
27 Subscriber Line Charge ("SLC") or increases to Qwest's basic service rates would have to be
28

1 accomplished through a rate case or within the Company's current price cap review filing.
2 While such changes may be revenue neutral and consistent with Scates, such a proposal would
3 require changes outside those contemplated within the scope of the current price cap plan that
4 was approved by the Commission. It is Staff's position that any changes to Basket 1 service rate
5 levels could only be made in the Company's price cap review proceeding.

6 Yet another option would be for the Commission to simply make policy determinations
7 in the context of this proceeding, and implement those policy determinations as applied to
8 specific rate elements within Qwest's current price cap plan review proceeding.

9 Finally, Staff believes that the changes to ILEC access rates would have to be made
10 within the context of a rate case, after consideration of the overall impact of the rate change upon
11 the rate of return of the companies and after a determination of fair value rate base. US WEST II
12 suggests that when a monopoly exists, that the traditional rate-of-return methodology used by the
13 Commission is proper. Additionally, the Commission's current Universal Service Fund rules
14 require no less from applicants seeking support thereunder.

15 RESPECTFULLY submitted this 3rd day of November, 2003.

16
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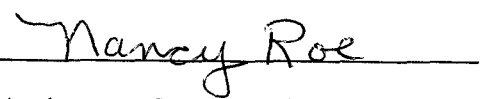
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